[4830-01-p] Published December 8, 2005

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

TD 9231

RIN 1545-BC49

Guidance on Passive Foreign Investment Company (PFIC) Purging Elections

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide specific elections that give relief to certain United States persons that continue to be subject to the PFIC excess distribution regime of section 1291 even though the foreign corporation in which they hold stock no longer satisfies the definition of a PFIC under section 1297(a). The final regulations affect U.S. persons owning stock in a PFIC.

DATES: Effective Date: These regulations are effective December 8, 2005.

Applicability Date: For dates of applicability, see §1.1298-3(f).

FOR FURTHER INFORMATION CONTACT: Ethan Atticks at (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1028, which was later incorporated into control number 1545-1507.

The collection of information in these final regulations is in §1.1298-3(c)(5). This information is required to enable the IRS to verify that a taxpayer is reporting the correct amount of income, gain or loss from that taxpayer's interest in the foreign corporation.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains final regulations under section 1298(b)(1). Section 1298(b)(1) was originally enacted as section 1297 by the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2085) and was redesignated as section 1298 by the Taxpayer Relief Act of 1997 (Public Law 105-34, 111 Stat. 788).

Section 1298(b)(1) provides that if a shareholder owns stock in a foreign corporation that, at any time during the shareholder's holding period with respect to such stock, was a PFIC that was not a qualified electing fund (QEF), the stock will retain its character as PFIC stock, even if the corporation later ceases to qualify as a PFIC under section 1297(a), unless the shareholder elects to purge the PFIC taint under rules similar to the rules of section 1291(d)(2).

On March 2, 1988, the IRS and Treasury Department published temporary regulations (TD 8178, 1988-1 CB 313 [53 FR 6770]), and proposed regulations that cross-referenced the temporary regulations (INTL 941-86 [53 FR 6781]), concerning the election under section 1298(b)(1) (then section 1297(b)(1)) (1988 temporary regulations). The 1988 temporary regulations permitted a shareholder of a former PFIC, as defined in §1.1291-9(j)(2)(iv), to purge the PFIC taint by making a deemed sale election. On January 2, 1998, the IRS and Treasury Department published temporary regulations (TD 8750; 1998-8 IRB 4 [63 FR 6]) and proposed regulations that cross-referenced the temporary regulations (REG 115795-97 [63 FR 39-01]) that amended the 1988 temporary regulations. The 1998 temporary regulations provided that a shareholder of a former PFIC that was a controlled foreign corporation (as defined in section 957(a)) during its last taxable year as a PFIC under section 1297(a), may apply the rules of the deemed dividend election under section 1291(d)(2)(B) and §1.1291-9 to its section 1298(b)(1) election. The 1998 temporary regulations expired on January 2, 2001, pursuant to section 7805(e)(2).

One written comment was received regarding the deemed sale election in response to the notice of proposed rulemaking published by cross-reference to the 1988 regulations. No public hearing was requested or held on the notice of proposed rulemaking. After consideration of the comment, the 1988 temporary regulations, as modified by the 1998 temporary regulations that permit a deemed dividend election in certain circumstances, are adopted as final regulations with the changes discussed below.

Summary of Comments and Explanation of Revisions

A. Time and Manner of Making the Deemed Sale Election

One comment was received on the 1988 temporary regulations regarding the deemed sale election under §1.1297-3T. The comment recommended that the regulations permit a shareholder to make a deemed sale election without having to file an amended return in instances where an election could be filed by the due date of the shareholder's original return for the last taxable year during which the foreign corporation continued to qualify as a PFIC under section 1297(a). This suggestion was adopted with respect to both the deemed sale and deemed dividend elections, and the regulations have been revised accordingly.

B. Additional Revisions

Additional revisions were made to the final regulations to reflect the redesignation of certain Code sections pursuant to the Taxpayer Relief Act of 1997 (Public Law 105-34, 111 Stat. 788). Similar revisions were made to the definition of former PFIC contained in §1.1291-9(j)(2)(iv). In addition, the deemed dividend election provisions were added and the deemed sale election provisions were revised to conform generally the elections under section 1298(b)(1) to the deemed dividend and deemed sale election provisions contained in §§1.1291-9 and -10 (purging elections in connection with election to treat PFIC as a QEF).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of this regulation is Ethan Atticks, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1291-9 is amended as follows:

1. Paragraph (i)(1) is removed.
2. The paragraph heading of paragraph (i)(2) is removed.
3. The text of paragraph (i)(2) is redesignated as paragraph (i).

4. Paragraph (j)(2)(iv) is revised.

5. Paragraph (j)(2)(v) is added.

The revision and addition reads as follows:

§ 1.1291-9 Deemed dividend election.

* * * * *

(j) * * *

(2) * * *

(iv) Former PFIC. A foreign corporation is a former PFIC with respect to a shareholder if the corporation satisfies neither the income test of section 1297(a)(1) nor the asset test of section 1297(a)(2), but its stock, held by that shareholder, is treated as stock of a PFIC, pursuant to section 1298(b)(1), because the corporation was a PFIC that was not a QEF at some time during the shareholder's holding period of the stock.

(v) Section 1297(e) PFIC. [Reserved]. For further guidance, see §1.1291-9T(j)(2)(v).

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Par. 3. Section 1.1297-0 is revised to read as follows:

§1.1297-0 Table of contents.

This section contains a listing of the paragraph headings for §1.1297-3.

Par. 4. Section 1.1297-3 is added to read as follows:

§1.1297-3 Deemed sale or deemed dividend election by a U.S. person that is a shareholder of a section 1297(e) PFIC.

[Reserved]. For further guidance, see §1.1297-3T.

Par. 5. Sections 1.1298-0 and 1.1298-3 are added to read as follows:

§ 1.1298-0 Table of contents.

This section contains a listing of the paragraph headings for §1.1298-3.

§ 1.1298-3 Deemed sale or deemed dividend election by a U.S. person that is a shareholder of a former PFIC.

(a) In general. A shareholder (as defined in §1.1291-9(j)(3)) of a foreign corporation that is a former PFIC, (as defined in §1.1291-9(j)(2)(iv)) with respect to such shareholder, shall be treated for tax purposes as holding stock in a PFIC and therefore continues to be subject to taxation under section 1291 unless the shareholder makes a purging election under section 1298(b)(1). A purging election under section 1298(b)(1) is made under rules similar to the rules of section 1291(d)(2). Section 1291(d)(2) allows a shareholder to purge the continuing PFIC taint by making either a deemed sale election or a deemed dividend election.

(b) Application of deemed sale election rules--(1) Eligibility to make the deemed sale election. A shareholder of a foreign corporation that is a former PFIC with respect to such shareholder may make a deemed sale election under section 1298(b)(1) by applying the rules of this paragraph (b).

(2) Effect of deemed sale election. A shareholder making the deemed sale election with respect to a former PFIC shall be treated as having sold all its stock in the former PFIC for its fair market value on the termination date, as defined in paragraph (d) of this section. A deemed sale is treated as a disposition subject to taxation under section 1291. Thus, gain from the deemed sale is taxed under section 1291 as an excess distribution received on the termination date. In the case of an election made by an indirect shareholder, the amount of gain to be recognized and taxed as an excess distribution is the amount of gain that the direct owner of the stock of the PFIC would have realized on an actual sale or disposition of the stock of the PFIC indirectly owned by the shareholder. Any loss realized on the deemed sale is not recognized. After the deemed sale election, the shareholder's stock with respect to which the election was made under this paragraph (b) shall not be treated as stock in a PFIC and the shareholder shall not be subject to taxation under section 1291 with respect to such stock unless the foreign corporation thereafter qualifies as a PFIC under section 1297(a).

(3) Time for making the deemed sale election. Except as provided in paragraph (e) of this section, the shareholder shall make the deemed sale election under this

paragraph (b) and section 1298(b)(1) in the shareholder's original or amended return for the taxable year that includes the termination date (election year). If the deemed sale election is made in an amended return, the return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the election year.

(4) Manner of making the deemed sale election. A shareholder makes the deemed sale election under this paragraph (b) by filing Form 8621 ("Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund") with the return of the shareholder for the election year, reporting the gain as an excess distribution pursuant to section 1291(a) as if such deemed sale occurred under section 1291(d)(2), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed sale election after the due date of the return (determined without regard to extensions) for the election year must pay additional interest, pursuant to section 6601, on the amount of underpayment of tax for that year. An electing shareholder that realizes a loss shall report the loss on Form 8621, but shall not recognize the loss.

(5) Adjustments to basis. A shareholder that makes the deemed sale election increases its adjusted basis of the PFIC stock owned directly by the amount of gain recognized on the deemed sale. If the shareholder makes the deemed sale election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of gain recognized by the shareholder. In addition, solely for purposes of determining the

subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of gain recognized on the deemed sale. A shareholder shall not adjust the basis of any stock with respect to which the shareholder realized a loss on the deemed sale, but which loss is not recognized under paragraph (b)(2) of this section.

(6) Treatment of holding period. If a shareholder of a foreign corporation has made a deemed sale election, then, for purposes of applying sections 1291 through 1298 to such shareholder after the deemed sale, the shareholder's holding period in the stock of the foreign corporation begins on the day following the termination, without regard to whether the shareholder recognized gain on the deemed sale. For other purposes of the Code and regulations, this holding period rule does not apply.

(c) Application of deemed dividend election rules–(1) Eligibility to make the deemed dividend election. A shareholder of a foreign corporation that is a former PFIC with respect to such shareholder may make the deemed dividend election under the rules of this paragraph (c) provided the foreign corporation was a controlled foreign corporation (as defined in section 957(a) (CFC)) during its last taxable year as a PFIC. A shareholder may make the deemed dividend election without regard to whether the shareholder is a United States shareholder within the meaning of section 951(b). A deemed dividend election may be made by a shareholder whose pro rata share of the post-1986 earnings and profits of the PFIC attributable to the PFIC stock held on the termination date is zero.

(2) Effect of the deemed dividend election. A shareholder making the deemed dividend election with respect to a former PFIC shall include in income as a dividend its

pro rata share of the post-1986 earnings and profits of the PFIC attributable to all of the stock it held, directly or indirectly on the termination date, as defined in paragraph (d) of this section. The deemed dividend is taxed under section 1291 as an excess distribution received on the termination date. The excess distribution determined under this paragraph (c) is allocated under section 1291(a)(1)(A) only to each day of the shareholder's holding period of the stock during which the foreign corporation qualified as a PFIC. For purposes of the preceding sentence, the shareholder's holding period of the PFIC stock ends on the termination date. After the deemed dividend election, the shareholder's stock with respect to which the election was made under this paragraph (c) shall not be treated as stock in a PFIC and the shareholder shall not be subject to taxation under section 1291 with respect to such stock unless the foreign corporation thereafter qualifies as a PFIC under section 1297(a).

(3) <u>Post-1986 earnings and profits defined</u>–(i) <u>In general</u>. For purposes of this section, the term <u>post-1986 earnings and profits</u> means the post-1986 undistributed earnings, within the meaning of section 902(c)(1) (determined without regard to section 902(c)(3)), as of the close of the taxable year that includes the termination date. For purposes of this computation, only earnings and profits accumulated in taxable years during which the foreign corporation was a PFIC shall be taken into account, without regard to whether the earnings relate to a period during which the PFIC was a CFC.

(ii) <u>Pro rata share of post-1986 earnings and profits attributable to shareholder's stock</u> --(A) <u>In general</u>. A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held by the shareholder on the termination date is the amount of post-1986 earnings and profits of the PFIC accumulated during any portion of the shareholder's holding period ending at the close of the termination date and attributable, under the principles of section 1248 and the regulations under that section, to the PFIC stock held on the termination date.

(B) <u>Reduction for previously taxed amounts</u>. A shareholder's pro rata share of the post-1986 earnings and profits of the PFIC does not include any amount that the shareholder demonstrates to the satisfaction of the Commissioner (in the manner provided in paragraph (c)(5)(ii) of this section) was, pursuant to another provision of the law, previously included in the income of the shareholder, or of another U.S. person if the shareholder's holding period of the PFIC stock includes the period during which the stock was held by that other U.S. person.

(4) <u>Time for making the deemed dividend election</u>. Except as provided in paragraph (e) of this section, the shareholder shall make the deemed dividend election under this paragraph (c) and section 1298(b)(1) in the shareholder's original or amended return for the taxable year that includes the termination date (election year). If the deemed dividend election is made in an amended return, the return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the election year.

(5) <u>Manner of making the deemed dividend election</u>--(i) <u>In general</u>. A shareholder makes the deemed dividend election by filing Form 8621 and the attachment to Form 8621 described in paragraph (c)(5)(ii) of this section with the return of the shareholder for the election year, reporting the deemed dividend as an excess distribution pursuant to section 1291(a)(1), and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed dividend election after the

due date of the return (determined without regard to extensions) for the election year must pay additional interest, pursuant to section 6601, on the amount of underpayment of tax for that year.

(ii) Attachment to Form 8621. The shareholder must attach a schedule to Form 8621 that demonstrates the calculation of the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC that is treated as distributed to the shareholder on the termination date pursuant to this paragraph (c). If the shareholder is claiming an exclusion from its pro rata share of the post-1986 earnings and profits for an amount previously included in its income or the income of another U.S. person, the shareholder must include the following information:

(A) The name, address, and taxpayer identification number of each U.S. person that previously included an amount in income, the amount previously included in income by each such U.S. person, the provision of law pursuant to which the amount was previously included in income, and the taxable year or years of inclusion of each amount.

(B) A description of the transaction pursuant to which the shareholder acquired, directly or indirectly, the stock of the PFIC from another U.S. person, and the provision of law pursuant to which the shareholder's holding period includes the period the other U.S. person held the CFC stock.

(6) Adjustments to basis. A shareholder that makes the deemed dividend election increases its adjusted basis of the stock of the PFIC owned directly by the shareholder by the amount of the deemed dividend. If the shareholder makes the deemed dividend election with respect to a PFIC of which it is an indirect shareholder,

the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of the deemed dividend. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of the deemed dividend.

(7) Treatment of holding period. If the shareholder of a foreign corporation has made a deemed dividend election, then, for purposes of applying sections 1291 through 1298 to such shareholder after the deemed dividend, the shareholder's holding period of the stock of the foreign corporation begins on the day following the termination date. For other purposes of the Code and regulations, this holding period rule does not apply.

(8) Coordination with section 959(e). For purposes of section 959(e), the entire deemed dividend is treated as having been included in gross income under section 1248(a).

(d) Termination date. For purposes of this section, the termination date is the last day of the last taxable year of the foreign corporation during which it qualified as a PFIC under section 1297(a).

(e) Late purging elections requiring special consent. [Reserved]. For further guidance, see §1.1298-3T(e).

(f) Effective date. This section applies for taxable years of shareholders beginning on or after December 8, 2005. However, taxpayers may apply the rules of this section to a taxable year beginning prior to December 8, 2005, provided the statute of limitations on the assessment of tax has not expired.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table:

<u>§602.101 OMB Control numbers</u>

* * * * *

(b) * * *

CFR part or section where Identified and described	Current OMB control No.
* * * * *	
1.1298-3…………………………………………………………………….	1545-1507
* * * * *	

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement

Approved: November 21. 2005

/s/ Eric Solomon

Acting Deputy Assistant Secretary of the Treasury